Markets Continue Positive Trajectory

The last three months seemed very apocalyptic. We witnessed the totality of a solar eclipse in the United States, followed by Hurricanes Harvey and Irma and raging wild fires in the West. Risks of potential man-made disasters rose as North Korea continued their testing of intercontinental ballistic missiles and hydrogen bombs. As we put the third quarter behind us and look ahead, we must pause and take an objective look at the data, keeping in mind the impacts of these massive hurricanes and increasing geopolitical risks have yet to be determined.

First, we consider U.S. Gross Domestic Product (GDP) because it is one of the primary indicators used to gauge the health of the U.S. economy. After yet another weak first quarter, which saw the U.S. economy grow by only 1.2%, GDP in the second quarter grew 3%, the fastest pace in two years. Initial estimates for third quarter growth were optimistically over 3%, but these estimates have been revised downward following the massive hurricanes.

Given low inflation and the aftermath from the hurricanes, the Fed Funds futures market is currently pricing in only a 30% chance of a rate hike before year-end. The Federal Reserve is, however, moving forward with its plan to unwind its large balance sheet, which stands at approximately $4.5 trillion. While inflation remains stubbornly low, employment data looks much better. The participation rate has been increasing slightly, even as many retire. The unemployment rate now stands at 4.4%, which is both low and within the Fed's target, signaling that the labor market seems to be healthy.

Economic hard data, such as housing starts, sales and revenues, has been encouraging, but not as positive as anecdotal data may indicate. "Soft data" gleaned through surveys of homebuilders, purchasers, manufacturers, and consumer sentiment, looks positive, although it is starting to decline slightly. Much of the soft data spiked after Trump was elected and has remained at high levels, but has started to moderate recently as the administration seems to be having trouble passing reforms. This is something we continue to watch closely. If this optimism fades, it will likely affect the market adversely.

Valuations in U.S. markets continue to be well above their historical averages on many different metrics. Looking at the S&P 500, Price to Earnings, Price to Book, Price to Sales and Price to Cost are all well above their 10- and 15-year averages. These high valuations are partially explained by low interest rates or discount rates, which support higher asset prices.

Entering into the fourth quarter, the 10-Year Treasury yield remains at lower than anticipated levels. The benchmark yield began the year at 2.45%, dropped to 2.31% at the end of the second quarter, and is currently at about that same level. Hurricanes and geopolitical factors have caused investors to seek safe assets like Treasurys, causing prices to go up and yields, which move inversely with prices, to go down. Going into 2017, we expected the yield on the 10-year Treasury to finish 2017 between 2.75% to 3.25%. Since inflation remains at lower levels, risks in general are increasing, and fiscal spending appears delayed until 2018, we are lowering this range by 25 bps, but we still expect that yields will move higher for the rest of the year.

Although stretched valuations continue to be a concern, we remain somewhat optimistic about equity market returns. On the positive side, low interest rates, a weaker U.S. dollar, and strong corporate earnings offer a solid backdrop to the equity markets. On the negative side, the difficulty the Federal Reserve faces trying to achieve a proper growth trajectory for the U.S. economy, increasing tensions with North Korea, and growing uneasiness out of Washington D.C. present significant risks. On balance, however, we would not recommend drastic deviations from long-term targeted allocations.

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